1992

Securities industry developments - 1992; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK
ALERTS

Securities Industry Developments—1992

Update to AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of securities broker-dealers with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Industry and Economic Developments

The securities industry appears to be heading toward its most profitable year since the stock market break of 1987. During the first two quarters of 1992, the industry as a whole posted profits in excess of $ 3.7 billion. The trend toward increased earnings has been supported by continuing high levels of underwriting activity and expansion of the market for derivative products. The investment banking sector of the industry, in particular, has been reaping the benefits of a recent surge of public stock offerings, resulting in substantial commission gains. While the outlook for economic recovery remains uncertain, cost consciousness still prevails and most broker-dealers are maintaining the lean organizational structures of recent years. The exception is the broker-dealers involved in derivative products such as interest rate swaps, "swaptions," cap agreements, floor agreements, commodity swaps, and equity-derivative products. The broker-dealers trading financial derivatives are adding personnel to their work force because of the complexity of the products, the need for system integration (extensive usage of microcomputers), and the demand for employees with expertise in these products.

Market Globalization

The move toward globalization of securities markets continues to be a significant factor in the operations of securities firms. There is an emphasis on entering new markets, particularly those in Russia (with an abundance of hard commodities because of the ample supply of natural resources), Eastern Europe, and Latin America. Since some foreign companies, as well as smaller U.S. companies, have had difficulty meeting the U.S. registration requirements, there has been an outcry by U.S. institutions for the Securities and Exchange Commission (SEC) to relax registration requirements on foreign and small company registrations. The goal is to "level the playing field" for foreign and small companies.

Deleveraging

Many broker-dealers that participated in the merger, acquisition, and leveraged buy-out excesses of the 1980s are now finding it necessary to refocus their operations and to reduce long-term debt and streamline their balance sheets. These broker-dealers are deleveraging, restructuring, and regrouping. The trend has been a severe decline in takeovers and an increase in initial public offerings, with an increased percentage of these offerings coming from once-publicly-traded companies that had been part of the leveraged buy-out craze of the 1980s. These "reverse leveraged buy-outs" are a way to take advantage of the highly valued stock market, pay down debt, and refinance at lower interest rates.

Regulatory Developments

The securities industry continues to be subject to a high degree of regulation aimed at preserving the integrity of the marketplace and maintaining investor confidence. The regulatory environment is a key element in designing audit strategy for a broker-dealer because of requirements that auditors of broker-dealers report on information included in supplementary schedules, on internal controls, and on compliance with specific rules dealing with financial responsibility and recordkeeping. The following is a summary of some of the recent regulatory developments that may affect the audits of entities in the securities industry.

Final Risk-Assessment Rules

The SEC has issued final risk-assessment rules 17h-1T and 17h-2T. The rules require that broker-dealers maintain and preserve records and other information and provide reports to the SEC regarding financial activities of affiliates that could have a material impact on the financial or operational condition of the broker-dealer. Broker-dealers who clear customer accounts and have less than $250,000 in capital, including subordinated debt, and broker-dealers who do not clear customer accounts or who are exempt from rule 15c3-3, and have less than $20,000,000 in capital, including subordinated debt, are not required to comply with the rules. The rules become fully effective, with regard to quarterly reporting for Material Associated Persons (MAPs), as defined, for the period ended December 31, 1992, with reports due 60 and 105 days thereafter. After two years, the SEC will review the effectiveness of these rules and make recommendations with regard thereto.

Determination of whether an affiliate or other associated person is a MAP requires consideration of (1) the legal relationship between the parties, (2) the financing arrangements of the broker-dealer and the associated person and the degree to which they are financially dependent on each other, (3) the degree to which the broker-dealer or its customers rely on the associated person for operational support or services, (4) the level of risk present in the activities of the associated person, and (5) the extent to which the associated person has the authority or ability to cause a withdrawal of capital from the broker-dealer.

The information to be filed on a quarterly basis on or with Form 17h and for which records must be maintained in a readily accessible place for three years (beginning with information for the quarter ended December 31, 1992) includes the following:

- Financial information
- Firm inventory amounts
- Off-balance-sheet items
- Unsecured credit extensions
- Current debt
- Summaries of real estate activities

Certain of these disclosures require special consideration of amounts over the "materiality threshold." This amount is the greater of $100 million, 10 percent of the broker-dealer's tentative net capital, or 10 percent of the MAP's tangible net worth.

Proposed Amendment—Minimum Capital Requirements

The SEC has proposed amendments to rule 15c3-1 relating to net capital (as defined in rule 15c3-1). As proposed, the amendments would require broker-dealers who hold customer funds or securities to maintain at least $250,000 in net capital. Those firms that clear customer transactions but do not hold customer funds, and that are exempt from rule 15c3-3 by virtue of paragraph (k)(2)(i), would be required to maintain at least $100,000 in net capital. Broker-dealers who introduce customer accounts to clearing firms would be required to maintain $50,000 or $100,000 in net capital, depending on whether they receive customer funds and securities occasionally or routinely. Furthermore, market makers would be required to maintain greater net capital in proportion to the number of securities in which they make markets.

Proposed Haircut Rules

The SEC is reviewing "haircut" rules that would apply to collateralized mortgage obligation (CMO) securities held by broker-dealers. Currently, CMOs issued by government agencies or quasi-governmental agencies, such as Fannie Mae or Freddie Mac, are afforded the same haircut treatment as U.S. government securities. Privately issued CMOs are afforded the same haircut treatment as corporate bonds, based on the CMOs' ratings. The SEC is considering creating a separate haircut treatment under which CMOs would be assigned haircuts related to their risk attributes.

The SEC is also continuing to review the haircut rules that apply to foreign equity securities. Current haircut rules that apply to such securities are based on where those securities are traded. The Securities Industry

Association (SIA) Capital Committee has recommended that the SEC move from identification of markets that are liquid to a more objective test in which given securities are recognized as liquid on the basis of inclusion in the *Financial Times Index.*

A haircut scheme for high-yield securities is currently being worked on as well, and the SEC is expected to issue a "no-action" letter in the near future.

NYSE Interpretation—Compensating Balances

The New York Stock Exchange (NYSE) has published an interpretation entitled *Compensating Balances Deposited With Others.* The interpretation states that compensating balances or other assets (such as cash, certificates of deposit, time deposits, commercial paper, etc.) deposited with or held by subordinated lenders, or lenders under a NYSE rule 328 fixed asset agreement, should be treated as assets not readily convertible to cash in calculating net capital. According to this interpretation, these balances should be treated as nonallowable assets up to the value of the liability to the lender.

The interpretation applies to deposits that, in substance, constitute support for existing borrowing arrangements. An example of such a deposit is one that is equal to all or a significant portion of the proceeds from a subordinated loan, particularly where the deposit and borrowing are proximately related in time. Since it may be difficult to determine whether a deposit supports existing borrowing arrangements, the interpretation states that deposits with lenders or their affiliates should be assumed to constitute such support unless the deposits are consistent, in fact, with customary day-to-day operations of similarly situated broker-dealers and, in any event, would still have been made had the borrowing not existed.

Marketability of Money Market Instruments

In response to a request by the SIA, the SEC issued a "no action" letter setting forth the specific circumstances in which various money market instruments issued by financial institutions (including so-called "936 money market instruments") would be deemed to have a "ready market" under subparagraph (c)(2)(vii) of rule 15c3-1 and, therefore, would not be subject to a deduction of 100 percent of their carrying value in computations of net capital.

CFTC Developments

The National Futures Association has finalized changes to its net capital rules for futures commission merchants (FCMs) and introducing brokers. These changes were finalized by the Commodities Futures Trading Commission (CFTC) on October 5, 1992 and will be effective as of December 31,

1992. The changes add two additional alternatives that must be considered by an FCM in determining the minimum amount of capital required to be maintained. The requirement becomes the greatest of: the existing requirement, or $6,000 for each sales office of the FCM, or $3,000 for each associated person (AP) (for example, commodity account executive) of the FCM or any introducing broker guaranteed by the FCM. The amended rules also increase the minimum dollar capital requirement for nonguaranteed introducing brokers from $20,000 to $30,000 and add the aforementioned alternatives.

The CFTC issued Interpretation 13, which formally states the agency's position that intercompany checks have no value for regulatory purposes —net capital, segregation—until the checks have actually cleared.

Audit Issues and Developments

Sophisticated Financial Instruments

Over the past several years, the financial markets have seen a proliferation in both numbers and types of sophisticated financial products. Some of the financial instruments with which auditors of broker-dealers should be familiar include—

- Interest rate swaps, which are agreements between counterparties to exchange periodic payments based on specific interest rate differentials applied to a specified notional amount. A swap allows one party to effectively change the interest rate structure of a debt obligation or of an investment through the exchange of payments with another party. Swaps enable participants to obtain financing from the cheapest markets and simultaneously hedge unwanted risks.
- Cap agreements, which provide that during a specified period a seller will pay a buyer the excess of the prevailing market interest rate over a specified index rate (cap index rate) on a notional amount whenever the index rate is above the protected interest rate on a rate determination date (option or ceiling rate). Cap agreements provide entities that have outstanding floating-rate debt with protection against rising interest rates.
- Floor agreements, which provide that during a specified period a seller will pay a buyer the excess of a specified minimum rate (floor) over a specified index market rate on a notional amount whenever the index rate falls below a specified rate. A floor agreement provides the owner of a floating-rate asset with a guaranteed minimum return.
- Interest rate swap options ("swaptions"), which allow buyers to enter into or exit an interest rate swap transaction at a future date at a specified interest rate based on a notional amount.

- Commodity swaps, which are similar to interest rate swaps except that the underlying index is usually based on the price of a commodity, such as metals, energy products, or grains.
- Equity-derivative products, which include longer-term warrants or options on indices or equities that are customized to a particular client's needs.

Auditors may find the following procedures useful in auditing sophisticated financial investments. The procedures are general in nature and should be tailored to the risks associated with the specific investments being audited:

- Review accounting records that detail transactions involving purchases and sales of investments in financial instruments of all types.
- Develop an understanding of the nature of the types of financial instruments in which the broker-dealer trades.
- Consider the propriety of the measurement and recognition principles used to account for each type of instrument.
- Assess the risks associated with each type of instrument and evaluate how those risks affect the realizability of the investment. Risks may include (1) credit risk (the risk that the issuer of the instrument or the counterparty to the investment transaction will be unable to make payment or otherwise complete the transaction at its scheduled maturity) and (2) market risk (the risk that fluctuations in interest rates may reduce the underlying value of the investment).
- Consider the propriety of the financial statement classification of the instruments and transactions in them and the adequacy of related disclosures.

The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, as more and more financial institutions enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counterparties that have higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used by the managements of broker-dealers to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. The substance of transactions in such instruments, rather than their form, should be a primary factor in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts.

High-Risk Transactions

Securities firms often engage in transactions that present inherent risks unique to the industry. Such transactions include—

- Securities lending, the inherent risks of which include the possibility that the counterparty will fail to return either the securities borrowed or the collateral, resulting in the need to buy or sell the securities at a possible loss.
- Repo transactions, which present risks similar to those presented by securities lending.
- Risk arbitrage, which involves investments in securities of entities that are engaged in mergers or tender offers. Such investments present exposure to the risk that the merger will not be completed successfully. Such aborted mergers may precipitate dramatic declines in securities prices resulting in loss to the investors.
- Tender offers, in which one company makes an offer for a specific number of shares of another company, reserving the option to accept all stock tendered over the minimum as well as a lesser number of shares. In this type of transaction, the price offered usually is substantially higher than the current market price of the securities. The risk, or exposure, to the firm relates to the possibility that the shares may not be accepted.
- Underwriting of securities. The inherent risks unique to underwriting securities include the possibility that underwriters may be required to purchase unsold securities positions offered pursuant to a firm commitment underwriting. As a result, a securities firm may need to finance the securities, assume the market risk of ownership, and take haircuts pursuant to rule 15c3-1. Underwriting securities also presents the risk that lawsuits may also be initiated by the purchasers of the securities under Section 11 of the Securities Act of 1933, which specifies that all persons (including underwriters) connected with a registration statement have responsibility for material misstatements contained therein. Securities underwriting also presents the risk that customers who have committed to purchase securities being underwritten may refuse to honor their commitments, resulting in the underwriter's having to purchase the securities.

COSO Report on Internal Control

In September 1992, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission issued its report *Internal Control—Integrated Framework*. The report defines internal control and its elements, provides tools for assessing internal controls, and addresses management reporting on internal controls over financial reporting.

The full report consists of four volumes: "Executive Summary" provides a high-level overview; "Framework" defines internal control and describes its various components; "Reporting to External Parties" provides guidance to entities that report publicly on internal control over preparation of their published financial statements; and "Evaluation Tools" provides material to help in evaluating an internal control system.

The four-volume set (No. 990002CL) costs $50; the "Executive Summary" (No. 990001CL) is available individually for $3. Prices do not include shipping and handling. To obtain either item, contact the AICPA Order Department (see order information on page 14).

The Confirmation Process

Auditors of broker-dealers frequently use confirmation in auditing customers' account balances and other financial statement balances. In November 1991, the AICPA's Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 67, *The Confirmation Process,* which provides guidance on the confirmation process in audits performed in accordance with generally accepted auditing standards. It defines the confirmation process, discusses the relationship of confirmation procedures to the auditor's assessment of audit risk, describes certain factors that affect the reliability of confirmations, and provides guidance on performing alternative procedures when responses are not received and evaluating results of confirmation procedures. SAS No. 67 specifically addresses the confirmation of accounts receivable and explicitly prohibits the use of negative confirmation requests when control risk is assessed at the maximum level. SAS No. 67 is effective for audits of fiscal periods ending after June 15, 1992. *Audit Risk Alert—1992* includes further discussion of SAS No. 67.

Service Auditor Reports

In April 1992, the ASB issued SAS No. 70, *Reports on the Processing of Transactions by Service Organizations,* which provides guidance on the factors auditors should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. SAS No. 70 also provides guidance for auditors who issue reports on the processing of transactions by a service organization for use by other auditors.

Because using service organizations affects both the auditor's understanding of the internal control structure and assessment of control risk, the guidance in this SAS should be considered by auditors of broker-dealers that use service bureaus for processing significant information or that issue reports on the processing of transactions for use by other auditors. *Audit Risk Alert—1992* includes further discussion of the provisions of SAS No. 70.

Accounting Developments

Right of Setoff

In March 1992, the Financial Accounting Standards Board (FASB) issued Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts.* The Interpretation defines *right of setoff* as used in Accounting Principles Board Opinion No. 10 and FASB Statement No. 105 and specifies what conditions must be met to have that right. It also addresses the applicability of that general offsetting principle to forward, interest rate swap, currency swap, option, and other conditional or exchange contracts and clarifies the circumstances in which it is appropriate to offset amounts recognized for those contracts in the statement of financial position. In addition, it permits offsetting of fair value amounts recognized for multiple forward, swap, option, and other conditional or exchange contracts executed with the same counterparty under a master netting arrangement. The Interpretation is effective for financial statements issued for periods beginning after December 15, 1993.

Fair Value of Financial Instruments

In December 1991, the FASB issued Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments.* The Statement requires disclosure of the fair value of financial instruments, both assets and liabilities, recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. If estimating fair value is not practicable, the Statement requires disclosure of descriptive information pertinent to estimating the fair value of a financial instrument. Certain financial instruments—for example, lease contracts, deferred compensation arrangements, and insurance contracts—are excluded from the scope of the Statement. FASB Statement No. 107 is effective for financial statements issued for fiscal years ending after December 15, 1992, except for entities with less than $150 million in total assets in the current statement of financial position. For those entities, the effective date is for fiscal years ending after December 15, 1995. *Audit Risk Alert—1992* includes further discussion of the provisions of FASB Statement No. 107.

Income Taxes

In February 1992, the FASB issued Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes,* which establishes financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years. It requires an asset and liability approach for financial accounting and reporting for income taxes. FASB Statement No. 109 supersedes FASB Statement No. 96, *Accounting for Income Taxes,* and amends or supersedes other accounting pronouncements (see appendix D of FASB Statement No. 109). FASB Statement No. 109 is effective for fiscal years beginning after December 15, 1992, with earlier application encouraged. The temporary differences created by the different bases of investments for book and tax purposes will result in a sizable deferred tax asset for many broker-dealers. Therefore, auditors of broker-dealers should be familiar with the criteria for recognition of a deferred tax asset, as well as with the guidance for establishing an appropriate valuation allowance. *Audit Risk Alert—1992* includes further discussion of the provisions of FASB Statement No. 109.

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This Audit Risk Alert supersedes the Audit Risk Alert *Securities Industry Developments—1991.*

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Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1992,* which was printed in the November 1992 issue of the *CPA Letter.*

Copies of AICPA publications may be obtained by calling the AICPA Order Department at (800) 862-4272. Copies of FASB publications may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

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